CC:IT&A:03
G.K. Matuszeski

OCT - 2 1991

District Counsel, Laguna Niguel
Attn: Sherri Spradley, Attorney

Assistant Chief Counsel (Income Tax & Accounting)

[redacted]

(TR-45-901-91)

This is in response to your request for assistance dated May 22, 1991, in which you asked whether a former spouse is entitled to a portion of an overpayment generated by her former husband's net operating loss (NOL), carried back from a year ending after the two were divorced to a year for which they filed a joint return.

CONCLUSION

The total overpayment is $[redacted], an amount larger than previous computed. [redacted] is entitled to the amount of the refund, $[redacted], he claims. [redacted] must file a timely claim in order to be refunded her share, $[redacted], of the overpayment.

FACTS

[redacted] and [redacted] filed a joint return for the tax year [redacted], showing taxable income of $[redacted], an investment credit of $[redacted], and total taxes of $[redacted]. The [redacted] (who hereinafter are referred to by their first names) were divorced in [redacted]. [redacted] remarried in [redacted] and apparently filed separately from his new spouse for [redacted]. [redacted] also incurred a large NOL in [redacted], which he carried back first to [redacted]. The tax year you specifically asked about is [redacted], for which [redacted] filed Form 1040X, Amended U.S. Individual Income Tax Return, carrying the unused portion of the loss to that year, and claiming a refund of $[redacted]. [redacted] did not sign the Form 1040X. For all the years involved, [redacted] and [redacted] were residents of California, a community property state.

LAW AND ANALYSIS

Section 172(a) of the Internal Revenue Code allows for the deduction of an NOL. As a general rule, under section 172(b)(1)(A), an NOL is carried back to each of the 3 taxable years preceding the loss.

Section 6013 of the Code provides for the filing of a joint return by a husband and a wife and imposes joint and several liability upon them for the tax computed on their aggregate liability.

Section 6402(a) of the Code provides in the case of any overpayment, the Secretary may within the applicable period of limitations credit the amount of the overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall refund the balance to such person.

Rev. Rul. 60-216, 1960-1 C.B. 126, holds that where there is a change in marital status by divorce in a community property state and, subsequently, one of the former spouses sustains an NOL, the loss may be carried back only to that portion of the taxable income reported on the joint return that is vested in the spouse sustaining the loss. Rev. Rul. 60-216 concludes that section 1.172-7(e) of the Income Tax Regulations pertaining to the treatment of NOL's of married couples assumes that the couple was married to each other during the entire carryback and carryover period. The regulations are therefore not applicable when the couple has divorced during the period.

Rev. Rul. 71-382, 1971-2 C.B. 156, holds that the rule originally established in Rev. Rul. 60-216 also applies in a community property state when one of the partners in a marriage has died. It contains a computation that demonstrates how the net operating loss of the surviving spouse is carried back and deducted against the income of a joint return.

Rev. Rul. 67-431, 1967-2 C.B. 411, accords the same treatment to investment credits as had been given NOL's in Rev. Rul. 60-216. In Rev. Rul. 67-431, one spouse, the husband, who had remarried, carried back investment credits to a year for which he filed a joint return with his former wife. Because the refund was only of taxes attributable to the husband on the joint return and because the Service had no knowledge of circumstances indicating that taxes were paid by anyone else, the refund check was made out to him alone. This holding was amplified by Rev. Rul. 80-7, 1980-1 C.B. 296.

Rev. Rul. 74-611, 1974-2 C.B. 399, holds that a husband and wife who file a joint return each have a separate interest in the jointly reported income and a separate interest in the overpayment.

Rev. Rul. 75-368, 1975-2 C.B. 480, deals with a claim resulting from an NOL carryback to a year the taxpayer had filed a joint return with his previous wife. The taxpayer incurred the NOL in a year when he was single. He subsequently married again and filed joint returns with his second wife. The revenue ruling holds that the claim will be valid even though it is only signed by him and the refund check will be made out only to him. The revenue ruling also provides a method of computing the refund.

Rev. Rul. 80-6, 1980-1 C.B. 296, modifies Rev. Rul. 75-368 by providing the method of computing the refund that is the same as that presented in Rev. Rul. 80-7, 1980-1 C.B. 45. Rev. Rul. 80-6 also states that Rev. Rul. 80-7 amplifies Rev. Rul. 67-431 by providing the method for determining the amount of the joint taxes attributable to the taxpayer and by providing a method for determining the amount to be refunded to the taxpayer.

Rev. Rul. 80-7 presents the separate tax method (or formula) for determining each spouse's share of an overpayment on a joint return. Under the formula, a spouse's tax liability under married filing separate (MFS) rates is divided by the total of each spouse's tax liability under MFS rates. The resulting fraction is then used to determine each spouse's share of the unassigned prepayment credits and of the tax liability. The difference between a particular spouse's share of prepayment credits and his share in the joint tax liability represents his share of the overpayment. However, the amount of overpayment credited to one spouse cannot exceed the amount of the joint overpayment. Rev. Rul. 80-7 concerns how much of an overpayment can be used against the prior liability of one of the spouses and does not involve an overpayment resulting from a claim.

Rev. Rul. 80-8, 1980-1 C.B. 298, applies the allocation formula in Rev. Rul. 80-7 to a claim filed by a former spouse, A, for a year A filed a joint return with B. A and B resided in a noncommunity property state. Only A signed the claim and A requested that the refund check be issued to A alone. The recomputed joint tax liability using MFJ rates is $3,484 and the joint overpayment is $3,184.

A's recomputed individual liability using MFS rates is zero, while B's is $5,350. Using the separate tax formula, A's separate tax of zero results in A's share of the recomputed joint tax liability, $3,484, also being zero. (Zero over any amount is zero. Zero times $3,484 is zero.) B's share is, therefore, the entire tax per return. (Under the separate tax method, B's

separate liability of $5,350 over the total of A's and B's separate liabilities, (0 + $5,350), results in a quotient of 1. That amount times the recomputed joint tax liability is again $3,484.

Under Rev. Rul. 80-8, A's and B's individual refunds are computed by subtracting each one's share of the joint tax liability from each one's withholding credits. A is therefore due a refund of $1,640 ($1,640 - 0) and B has a potential refund of $1,544 ($5,028 - $3,484). Rev. Rul. 80-8 holds that the Service will issue A the $1,640 refund in A's name alone and will issue B the $1,544 refund, if B files a timely claim for that amount.

Rev. Rul. 85-70, 1985-1 C.B. 361, applies the separate tax formula in Rev. Rul. 80-7 to community property states. The revenue ruling holds that the formula is generally acceptable in a community property state in computing refund allocations where the spouse's income is from wages. Although the spouses may have earned different amounts of wages, each spouse in a community property state is considered to be the recipient of one-half of the aggregate wages of the couple. Each spouse is also entitled to a credit for one-half of the taxes that are withheld on the wages. Accordingly, when the formula is used, each spouse has a one-half interest in the overpayment. The Service will not use the formula if the spouses present proof that tax credits came form a source other than community property.

Rev. Rul. 86-57, 1986-1 C.B. 362, applies the principles enunciated in Rev. Rul. 80-8 to an NOL carryback. Rev. Rul. 86-57 holds that a divorced taxpayer is entitled to a refund of tax for the taxpayer's interest in a joint overpayment created by a net operating loss on a former spouse's separately filed return. Under the facts of the case, both the taxpayer and the former spouse filed claims for refund from the NOL carryback.

Rev. Rul. 86-57 also demonstrates the refund received by the spouses on the original return must also be allocated between them using the separate tax formula. Using the income figures on the original return, each former spouse's share of the prior joint tax liability is determined under the separate tax formula. This share is then compared with their respective original payments of the liability, e.g., withholding credits, to determine how the original refund should be allocated. For example, under the facts of the revenue ruling, spouse A's share of the joint liability exceeded A's withholding. The refund was therefore attributed solely to the payments of the other spouse.

In this case, in order to determine the amounts that may be refunded to [redacted] and [redacted] respectively, a two-step process

must be followed. First, the total overpayment must be computed under the principles of Rev. Rul. 60-216 and Rev. Rul. 71-382. Second, that overpayment must be allocated between the spouses.

TOTAL OVERPAYMENT

Pursuant to section 172(b) of the Code, [redacted] carried the NOL originating in [redacted] back to [redacted] and then applied the unused portion to [redacted]. Because [redacted] was not married to [redacted] at the end of [redacted], the NOL may only be used against his share of the income when it is carried back to years in which they filed joint returns. Rev. Rul. 60-216. [redacted] and [redacted] each have separate interests in the income and overpayment on the joint return. Rev. Rul. 74-611. We assume that [redacted] and the Appeals Office are correct that all the items of income and deduction should be split in half in accordance with rules applicable to community property states, i.e., that no item originates from separate, rather than community, property.

We believe that neither [redacted] nor the Appeals Office has computed the overpayment for [redacted] correctly. [redacted] filed Form 1040X attempting to change the [redacted] filing status from joint to married filing separately and then reduced his separate income to zero. This results in a claimed refund of one-half the tax shown on the original return, $[redacted]. The Appeals Office correctly did not allow the change in filing status but also split not only the income but the net tax per return in half and is viewing [redacted]'s half, i.e., $[redacted], as the overpayment.

Instead, as demonstrated by the example given in Rev. Rul. 71-382, only the taxable income on the [redacted] return should be split to determine the new tax per return. [redacted]'s half of the taxable income is $[redacted]. The NOL carryover in the present case is larger than $[redacted], so [redacted]'s share of the taxable income is reduced to zero. However, [redacted]'s share (zero) must then be added back to the one-half of the original taxable income, $[redacted], that is [redacted]'s and is still on the joint return. The sum ($[redacted]) is taxed at MFJ rates. The MFJ tax on $[redacted] from tax tables for [redacted] is $[redacted].

We assume the investment credit on the [redacted] return originates from community property and should also be split in half, resulting in an investment credit of $[redacted] on the joint return. The net tax per return is then $[redacted] ($[redacted] - $[redacted]). Therefore, the overpayment is $[redacted], representing the prior net tax per return, $[redacted], minus the new net tax per return, $[redacted]. This assumes, of course, that there have been no intervening deficiencies or rebates.

AMOUNT OF OVERPAYMENT DUE EACH FORMER SPOUSE

Now that we have determined the amount of the overpayment, we must determine how much may be refunded to each spouse. Although Rev. Rul. 85-70 states each spouse in a case like this would have a one-half interest in the overpayment, the revenue ruling does not deal with the additional circumstance found here of one spouse's income being reduced by an NOL deduction.

We first determine each spouse's share of the recomputed tax liability using the separate tax formula, as presented in Rev. Rul. 80-7 and as applied in Rev. Rul. 80-8. [redacted]'s tax liability here, like A's in Rev. Rul. 80-8, has been reduced to zero. In order to simplify the computation presented there, we know that [redacted]'s fraction under the separate tax formula will be reduced to a quotient of zero and [redacted]'s will be reduced to a quotient of 1. As a result, [redacted]'s share of the recomputed tax will be zero (0 x $[redacted]) and [redacted]'s share will be $[redacted] (1 x [redacted]). Put more simply, since [redacted] is no longer liable for any of the tax per return, [redacted] is now liable for all of it.

We will also use the separate tax formula to determine each spouse's contribution towards payment of the prior tax liability. To do this, we apply the formula in Rev. Rul. 85-70 and Rev. Rul. 86-57 to the prior tax liability and the prior refund on the [redacted] return. All of the [redacted] tax liability was paid by withholding credits. Under Rev. Rul. 85-70, the withholding credits, $[redacted], are split in half between [redacted] and [redacted]. One-half of $[redacted] is $[redacted]. Under our assumptions that all the income and deductions on the [redacted] return are from community property, each of the former spouses share of the couple's prior joint net tax liability, $[redacted], is also one-half, or $[redacted]. Rev. Rul. 85-70.

Therefore, the prior refund, $[redacted], which is the difference between the withholding credits and the prior tax liability, is also attributed one-half, or $[redacted], to each spouse. Rev. Rul. 85-70 and Rev. Rul. 86-57. As a result, under the computation shown in Rev. Rul. 86-57, each former spouse's contribution towards the payment of the prior tax liability is $[redacted]. That is, for each former spouse, one-half of the withholding credits, $[redacted], minus one-half of the prior refund, $[redacted], is $[redacted].

Each former spouse's share of the overpayment is the difference between the each spouse's contribution toward the payment of the prior tax liability minus his or her share of the recomputed tax liability. Rev. Rul. 86-57. Therefore, [redacted]'s share is $[redacted] ($[redacted] - 0) and [redacted]'s share is $[redacted] ($[redacted] - $[redacted]). These two individual shares added together ($[redacted] + $[redacted]) equal the overpayment of $[redacted].

[redacted] may be refunded his share of the overpayment even though only he signed the claim and the check can be made out only to him. Rev. Rul. 75-368 and Rev. Rul. 80-8. [redacted] must file a timely claim in order to receive a refund of her share of the overpayment. Rev. Rul. 80-8 and Rev. Rul. 86-57.

We hope this answers your concerns in this matter. If you have any further questions please call Grace Matuszeski at (202) 566-4430.

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(signed) Michael D. Finley
By _____
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